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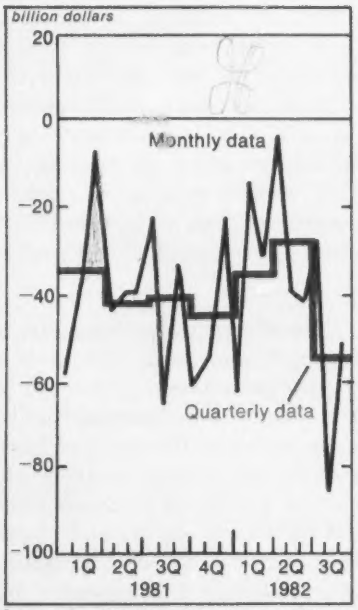
The U.S. Current Account Moves Into Deficit

After tending toward balance or small surplus since 1978, the U.S. current account appears to have turned negative. Although data on recent service payments are not yet available, the swing in the trade balance appears to have been strong enough to result in a deficit on current account of close to $4 billion in the third quarter. Over the first half of the year the current account was in *surplus* by $3.5 billion. Thus, although fourth-quarter performance should be somewhat stronger than that of the third quarter, the U.S. current account now seems destined to show a small deficit for the year as a whole. If, as seems likely, the economic rebound next year is stronger in the United States than in the rest of the world, the U.S. current-account deficit for 1983 could be relatively large—perhaps $15-20 billion.

U.S. trade balance*



*Seasonally adjusted annual rate, f.a.s.-c.i.f.

It is fashionable to ascribe this turnaround to the strength of the dollar. But while the strong dollar has certainly tended to curb exports and encourage imports, the surge in the third-quarter trade deficit was more the result of other economic forces: including a pickup in oil imports stemming from inventory increases and the general slowdown in world trade. While American exports have fallen steadily since the first quarter of 1981, the U.S. share of all industrialized country exports has been fairly stable since mid-1981. Over the past 15 months, the decline in U.S. exports thus appears more related to the worsened growth performance of America's major trading partners, particularly Canada and the developing countries, than the worsened competitive position of U.S. exporters. The role of the strong dollar is somewhat more evident on the import side. While the dollar value of non-oil imports has been reasonably stable since mid-1981—and has actually declined relative to nominal GNP—the volume of imports and the ratio of imports to GNP in constant prices have continued to rise.

The outlook for a worsened U.S. current account performance is not only a matter of a larger deficit in merchandise trade, however. After increasing steadily since 1975, the huge U.S. surplus in services transactions appears likely to shrink somewhat next year. This is due in part to the outlook for lower earnings from U.S. direct investments abroad. But the key element here is the prospect of declining net foreign interest receipts resulting from lower Eurodollar interest rates. Even a good wind blows some ill.

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New Dutch government plans stringent policies to help tame deficit.

Despite Holland's continuing recession—industrial output has been basically flat for almost two years—the country's soon-to-be-inaugurated government has agreed to a policy of austerity. A center-right Christian Democrat-Liberal coalition with a comfortable 12-seat parliamentary majority is about to form a government that will be led by Ruud Lubbers, a former economics minister and successor to Dries van Agt as the head of the Christian Democrats. The new government hopes to reduce the Netherlands' public-sector deficit to less than 10% of national income from an estimated 10.5% in 1982. Spending cuts of 13 billion guilders—larger than previously planned—are envisaged for 1983, and tax thresholds will be less than fully adjusted to the inflation rate. Nevertheless, because exports account for over half of the country's GDP, the main influence on economic growth will be developments in the remainder of the EEC, where demand is expected to remain weak at least until mid-1983.

Despite economic downturn, reduction of current-account deficit remains primary Icelandic goal.

The Icelandic economy is now entering a downswing. The country's all-important fish catch will be close to one-half of its 1981 level, while prospects for energy-intensive exports, such as aluminum and ferrosilicon, have been dimmed by the continuing world recession. Current forecasts point to a 3.5% decline in GNP in 1982, following a 1.5% increase in 1981. The current-account deficit is expected to swell to some 10.4% of GNP, compared with last year's 4.9% figure. Despite mounting political pressures as the next election draws nearer—it is generally expected before the spring of 1983—the government has made it clear that a reduction in the current-account gap is its main objective, ruling out any counter-cyclical policies that might endanger this goal. As a result, most forecasters are expecting a narrowing of the payments gap to some 6.0% of GNP in 1983, while GNP itself is expected to decline by a further 2.7% compared with 1982's figure.

Signs of an economic turnaround for Argentina.

The Argentine economy is beginning to show signs of revival after 18 months of declining activity. Since early 1981, the country's business and industrial sectors have been buffeted by soaring inflation, high interest rates, foreign-exchange instability, and war dislocations in trade and finance. Now, owing to the government's program of negative real interest rates and trade and exchange controls, sales and production have started to pick up in some sectors. Moreover, manufacturing turned up slightly over July-September, the agricultural sector is enjoying an excellent grain harvest, and the government recently adopted a new unified exchange-rate system. But despite these encouraging developments, the country still faces a 175% rate of inflation and deep concerns about its external debt and reserves position. An IMF standby program, currently being formulated, could help to alleviate these problems. Such an agreement might not only aid in price stabilization, but also shore up Argentina's foreign reserves and its debt-servicing capabilities.

Israeli economy suffers few ill effects from Lebanon conflict.

The Israeli economy so far has shown no signs of any major disruption as a result of the conflict in Lebanon. Real GDP growth may be as high as 4% this year, following growth of 4.7% in 1981. The principal sources of strength have been private consumption and the surprising buoyancy of investment. The prospects for 1983, however, are not quite so bright, owing to the recent tightening of fiscal policy and continued recession in Israel's major overseas markets. Moreover, the economy remains beset by inflation and balance-of-payments difficulties. The world recession has limited demand for Israeli exports and played a part in what is likely to be a $500 million deterioration in the civilian deficit on goods and services this year. Overall, the current account will register a deficit similar to the $1.5 billion gap recorded in 1981. Finally, inflation may average around 125% in 1982 after last year's 116.8%. The increase reflects, in large part, a deliberate move by the government to reduce subsidies on many items in the first half of the year. More recently, however, this policy has been reversed, suggesting a slower pace of price rises in the latter part of the year.

Bond markets rally in Australia.

Falling interest rates, new debt issuance procedures, and a striking inflow of foreign capital have drawn increasing attention to the Australian capital markets in recent months. Long-term interest rates have dropped off sharply. For example, successful tenders for the A$675 million in government bonds offered in September produced yields about 130 basis points below those produced by a A$350 million issue last July. Yields continued to fall in the secondary market as well, until the new bonds were priced to yield about two percentage points less than two months previously. And the downtrend in rates is expected to continue. In addition to the rate decline, the Australian financial markets have been getting a boost from the successful introduction of a new tender system for selling government bonds and from heavy investment by Japanese financial institutions. Capital inflows in September rose to A$1.68 billion from A$346 million in August. And most of the A$600 million invested in government and quasi-government securities represented Japanese capital. The influx of Japanese funds not only will help to hold interest rates down, but also should tend to slow the fall of the Australian dollar.

Chile hopes to cut unemployment, return to positive growth.

Chile is attempting to pull out of its currently depressed level of economic activity. The economy now faces the prospect of a 13% drop in real growth this year. This would be a striking turnaround from the previous five years when real GDP expanded at a rate of 7.8% per annum. Industrial output and retail sales are considerably below their year-ago levels, and unemployment has climbed to 24%. The economic downturn has been blamed largely on international recession, high world interest rates, soft export prices for copper, and an overvalued exchange rate. And now—although it will inevitably mean an increase in inflation from the unusually low annual rate of 4.5% posted in the second quarter—the Chilean government is trying to stimulate a recovery by establishing a regular crawling-peg devaluation of the currency in the hope of boosting exports. At the same time, a $900 million IMF assistance program is being secured to rebuild reserves.

Foreign investment up sharply in Taiwan.

Taiwan's Ministry of Foreign Affairs has released statistics indicating that foreign direct investment rose an extraordinary 83.8% in the first six months of 1982 compared with the same period last year. By far the largest share—some 55%—of the total $212.1 million invested represented Japanese funds, while U.S. investments accounted for 22% or $46.9 million. Given the severity of Taiwan's current economic slump, such inflows are welcome. Real growth reported thus far this year has averaged only around 3.5%—notably lower than 1981's 5.5% and far below the 8% annual growth target set by the government's latest four-year plan. Most forecasters are calling for an extremely slow recovery as Taiwan continues to await a turnaround in world demand for its exports. Nevertheless, foreign investors undoubtedly have great confidence in the country's long-run outlook.

No turnaround in sight yet for world wheat market.

World wheat production for 1982/83 is forecast at 449.0 million metric tons—less than 1% below last season's record level of 453.3 million tons, but still above earlier forecasts. Higher-than-expected output in the United States, Argentina, Mexico, Europe, and South Africa will offset (in terms of world trade) Australia's crop loss from drought and the Soviet Union's production decline. Weak world consumption is expected to continue, causing stock buildups for the second consecutive year and leading to continued downward pressure on already low prices. Canada, Argentina, France, and Australia are gaining USSR import commitments even as U.S.-Soviet trade declines. U.S. stocks will probably absorb most of the excess production because of the current USSR pursuit of decreased dependence on American grain. As Soviet crops improve, import needs will continue to decline, constricting the market for U.S. exports even further.

Capital Spending Outlook Not So Bleak

Unquestionably, the most glaring negative element in the preliminary third-quarter GNP figures released by the Commerce Department was the 13% decline in real non-residential fixed investment. This represented more than an 8% reduction in investment in structures and a 15% cut in equipment spending. Prospects for future capital spending are similarly dim. But while it is true that a recovery in business investment will lag behind the turnaround in production, several forces are already at work to improve its outlook.

The strongest argument *against* the prospect of a rebound in capital spending is the less-than-70% level of capacity utilization. The notion is that as production expands, corporations will first use existing plant and equipment before buying new machinery. However, this does not mean that firms will use *all* the available capital stock before expanding capacity. Technological progress, particularly in such heavy industries as steel, has rendered much of the existing equipment obsolete. As a result, the appropriate level of full utilization is much less than 100% and, in fact, has been falling over time. At the last cyclical peak, capacity utilization was 85%; this time, it might be around 82%. And even this figure is only a broad average, which masks much lower capacity constraints in some industries.

Another consideration is the sharp drop that has occurred in interest rates, especially in long-term bond yields. Moreover, although further modest improvement can be expected in inflation, the recent change in Federal Reserve policy creates the circumstances for an easing of monetary pressures and a further decline of interest rates well into 1983. As a result, there should be significant progress in reducing the level of real interest rates. This development will improve the prospective profitability of investment projects and encourage capital spending.

Finally, recent legislative changes, which many observers felt would discourage business investment by repealing safe-harbor leasing, actually contain sufficient positive provisions to ensure no real reduction in these activities. Specifically, although lessors who buy tax benefits from ailing lessees through sale-and-leaseback agreements must spread out investment tax credits and depreciation allowances over longer periods, several industries—such as steel, automobiles, and aircraft producers—obtained deadline extensions. Moreover, in January 1984, when most safe-harbor leasing transactions will be phased out, a new type of lease, called a "finance" lease, will be phased in. This will permit many of the same type of tax transfers sanctioned under the safe-harbor leasing.

Carl Alan Batlin

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
			6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, lions of d
Africa	Algeria	Government spending expected to grow by 10% in 1983.	Aug.	−31%	36.0°	1,935	Sept.	2,555	−32%	1.0	
	Congo	Extensive road building program begun to aid development of agricultural sector.	Dec.	+18%	1.2	735	May	112	−20%	1.7	
	Egypt	New law introduced to encourage investment.	May	−31%	22.7°	535	Aug.	597	−10%	0.8	65
	Liberia	Gov't. budget for fiscal 1982-83 is $420 million, $11 million below year earlier.	June	−17%	1.1°	570	Sept.	10	−55%	0.3	124
	Morocco	Economy expected to grow by about 5% this year.	May	− 4%	18.1°	896	Aug.	143	−16%	0.4	763
	Nigeria	Planned $2.5 billion railway postponed indefinitely owing to financing difficulties.	Aug.	−13%	86.8	1,125	Aug.	1,399	−82%	1.0	
	South Africa	Rapid inflation, high interest rates, and rising unemployment pare back consumer spending.	Aug.	−16%	78.4	2,601	Sept.	602	+48%	0.4	
	Sudan	Greater incentives to farmers raise commodities output; cotton crop up dramatically.	March	−26%	9.0	482	Sept.	26	+ 5%	0.3	492
	Tanzania	Industries running at about 35% of capacity.	Sept. '81	+24%	6.2	338	April	15	−33%	0.2	8
	Tunisia	Sixth five-year plan launched; job creation a priority.	July	−14%	8.1	1,240	Aug.	530	− 8%	1.8	
	Uganda	Private investors return to tea estates and sugar industry.	n. a.	n. a.	3.5°	280	n. a.	n. a.	n. a.	n. a.	248
	Zambia	Shortages of materials sharply curtail manufacturing output.	Dec.	−23%	3.4	575	Aug.	63	+21%	0.6	640
	Zimbabwe	Real GDP growth expected to slow to 3% this year, could turn negative in 1983.	Dec.	−15%	6.7	870	Dec.	230	− 3%	2.0	40
Middle East	Jordan	Industrial production grew only 0.6% in first half of 1982.	March	+24%	4.5	1,341	Sept.	953	−18%	3.5	
	Kuwait	Gross value of outstanding forward-dated stock market checks officially put at $91.6 billion.	May	−30%	24.3	17,350	Sept.	4,691	+21%	7.2	
	Qatar	No decision made yet on exploitation of gas reserves.	Aug.	−27%	5.0°	23,000	Sept. '81	347	−10%	2.3	
	Saudi Arabia	Public Investment Fund's domestic loan commitments rose to $23 billion at midyear.	Aug.	−32%	155.8	16,719	Sept.	30,330	+ 3%	10.8	
	United Arab Emirates	Government agrees in principle to establishment of local stock market.	June	−21%	29.8	29,780	Sept.	3,156	+12%	4.1	

°1980

Sizing Up the New Deposit Service

Commercial banks and thrift institutions will soon be offering their customers a new money market deposit account. Although it should prove popular with depositors, the new account still faces some problems that could limit its attractiveness.

Recent legislation directed the Depository Institutions Deregulation Committee (DIDC) to issue regulations, which would take effect in mid-December, authorizing an account that is "directly equivalent to and competitive with money market mutual funds . . ." The DIDC has already indicated that the new regulations will reflect: (1) no minimum maturity, (2) no interest-rate ceiling, (3) an initial minimum denomination no greater than $5,000, (4) up to three pre-authorized or automatic transfers and three other third-party payments (including drafts) per month without being subject to transaction-account reserve requirements, (5) availability to all depositors, and (6) deposit insurance up to $100,000.

A decision is imminent on a number of important issues that the DIDC will have to resolve. First, although the new account, as described by the DIDC, would ". . . not be subject to transaction account reserves . . .," so far there is an ominous silence about *other* reserve requirements. While under 1980 legislation Congress eliminated reserve requirements on time deposits held by individuals, "non-personal" reserve requirements could conceivably be imposed by the Federal Reserve.

Second, the DIDC is apparently deferring action on a new account having unlimited payments features. Adoption of such an account would substantially enhance the efficiency of the payments system.

Third, the DIDC is considering imposing minimums on initial deposits to the account, balances to be maintained thereafter, and transfers. Limitations are also under review covering credit connected to the account, telephone transfers to other accounts of a depositor, and deposits *to* the account.

Two conclusions can be drawn from events to date. First, although congressional intent is reasonably clear (despite some fuzziness in the statutory language), regulatory embellishments threaten to curb the attractiveness of the account. Indeed, some steps now under consideration would constitute "re-regulation." While the account will no doubt be attractive, as both a saving and limited transacting vehicle, it could be better.

Second, virtually any success for the account will reduce recorded M1 growth during 1983, thereby providing considerable latitude for Federal Reserve policy. As a result, of course, M1 probably will be even less useful as a gauge of monetary policy during 1983 than it was in 1982. That suggests—assuming no changes in the definitions of the aggregates—that M2 is likely to take on greater importance relative to the other policy variables. However, it does not necessarily follow that M2 will have the major policy role in 1983 that M1 had during much of the past three years.

Richard C. Aspinwall

AYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
F. ars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	November 3, 1982		current monetary conditions	
	Gas exports forecast to reach $4 billion in 1983.	Dec. '80	+10%	Dec. '81	+16%	.2153	— 8%	Admin. procedures reported to have delayed payments.	Algeria
	Oil companies increase capital imports for exploration and development.	Dec.	+13%	May	+19%	.002766	—23%	Time deposits on steady uptrend.	Congo
	Oil export revenues were $2.7 bn. in FY 81/82, unchanged from previous year.	June	+16%	July	+26%	.9879	—20%	June private credit up 59.3% from year earlier.	Egypt
	IMF loan of $89 million will assist balance of payments.	June	+ 6%	March	— 4%	Par	—	Private-sector liquidity increased in second quarter.	Liberia
	Current-account deficit projected at $1.9 bn. for 1982, up slightly from 1981.	March	+15%	Feb.	+15%	.1600	—14%	Growth of claims on private sector slows.	Morocco
	Import deposits for raw materials and spare parts to be cut to 10% from 25%.	Dec.	+17%	June	+ 5%	1.4700	— 4%	Accumulated trade debts now at $3-5 billion.	Nigeria
	Current-account deficit narrowing because of higher gold prices and lower imports.	Aug.	+14%	July	+24%	.8610	—18%	Post office enters the capital market.	South Africa
	Foreign indebtedness now estimated at $6-8 billion.	n. a.	n. a.	July	+28%	1.1100	—16%	Further devaluation of currency likely.	Sudan
	IMF and World Bank aid being actively sought.	Dec.	+23%	n. a.	n. a.	.1809	n. a.	Foreign reserves virtually depleted.	Tanzania
	Current-account deficit this year officially forecast at $680 million.	May	+13%	July	+14%	1.5620	—24%	May private-sector credit growth rose to 29%.	Tunisia
	World Bank loans to aid imports of critical spare parts, raw materials.	n. a.	n. a.	April	+55%	.0101**	—19%	Two-tier exchange-rate system introduced.	Uganda
	Foreign-exchange decline causes severe restrictions on non-essential imports.	Sept. '81	+15%	May	+ 5%	1.0478	— 8%	IMF seeks devaluation of kwacha.	Zambia
	Restraints hold imports at one-third below mid-1981 levels.	March	+13%	April	+ 6%	1.3000	n. a.	Likelihood of devaluation increases.	Zimbabwe
	First-quarter 1982 exports 33% above year-earlier level.	July	+ 7%	June	+13%	2.7816	— 5%	M2 growth declined to 18.2% in July.	Jordan
	Oil production remains flat at 650,000 barrels per day.	Dec.	+ 7%	July	+50%	3.4471	— 3%	Liquidity remains tight.	Kuwait
	September oil output down to 287,000 barrels per day.	n. a.	n. a.	Dec. '81	+50%	.2748	0	Money supply growing more slowly.	Qatar
	Oil production only 5.8 million barrels per day in August.	June	— 1%	April	+21%	.2908	— 1%	Domestic liquidity tighter.	Saudi Arabia
	Oil production steady at 1.15 million barrels per day.	n. a.	n. a.	July	+15%	.2724	0	June private credit rose 14.5%, year-on-year.	United Arab Emirates

** most items

World Interest Rates

market rates of Nov. 3, 1982; bond yields as of Oct. 29, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.50	11.46	9.625 intervention rate	12.00	9.50	6.00	18.00 penalty rate 21.00	6.00	5.00	5.50*
Day-to-Day Money	9.375 November 4	13.00	9.625	11.80	13.50	7.10	18.75	6.625	1.75 1-month Euro-Swiss fr. rate	7.00*
Treasury Bills 91-day, Middle Rates	7.77	11.05	8.75	12.75	n. a.	n. a.	16.958 87 days	no dealing	no market	5.625* two-month
Commercial Paper prime, 3-month, asked	9.00 finance paper discount basis	11.35 finance paper 15% tax w/h	8.519	11.90 Certified	13.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.80	11.25 15% tax w/h	8.625	11.90 Certified	not traded	8.05	16.90	no market	3.75	no market
Government Bonds Long-term, new and old issues, average yield	10.74	12.20	10.18	8.972 20% tax w/h	15.04	8.10	19.42	9.09	4.30	8.202
Industrial Bonds prime, long-term, new and old issues, average yield	12.05 Aa Industrials	13.00	11.68	14.904	16.10	8.15	19.65	9.62	5.81	6.76
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.75	10.50	16.00	15.20	11.50	20.75 ⅛ qtrly fee on outstdng.	8.50	8.50	6.00*
Bank Time Deposits 3-month	8.875 Cert. of Dep.	11.25	9.0625	12.55	13.25	7.10	11.50	6.625 large deposits	3.00 residents only	3.755*
Eurocurrencies 3-month, asked	9.625	11.625	9.25	no market	19.50	7.00	no market	6.5625	3.4375	7.125
Exchange Rates—in U.S.$ rates floating against the $	—	.8180	1.6750	.0202	.1386	.3892	.000685	.3591	.4520	.0036
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.80 *D*	.60 *P*	3.25 *D*	9.75 *D*	2.75 *P*	13.25 *D*	3.51 *P*	6.25 *P*	2.75 *P*

Eurodollar Deposits
(London, interbank, bid)
November 4

7-day	9.50
1-month	9.375
3-month	9.625
6-month	9.6875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.46
U.S.-Canada Treasury Bills	−1.036
U.S.-Canada Finance Co. Paper	−0.394
Eurodollars-U.K. Local Auth. Deposits	+0.088

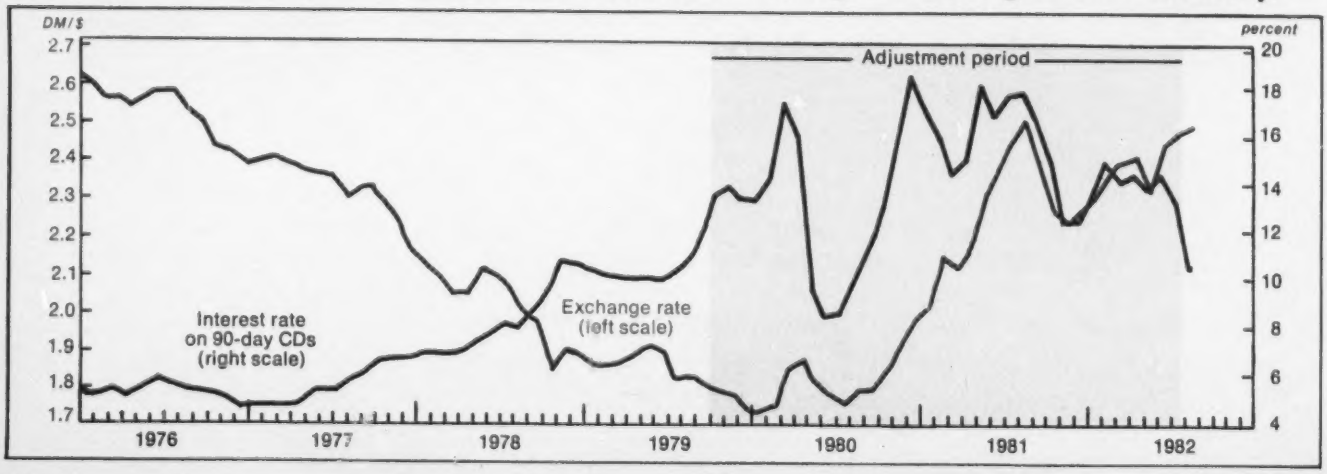
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.00
Over 7 yrs.	11.25
DM Bonds	
7 yrs. and under	8.625
Over 7 yrs.	8.50

Gold Price
London afternoon fixing
427.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of October 27, 1982.

Interest rates and the value of the dollar: Returning to the long-run relationship



Exchange Rates: Back to Long-Run Basics

Foreign-exchange forecasters have had a rough life since the Bretton Woods system of fixed exchange-rates was replaced by an ostensibly floating-rate system that has been sometimes managed and often mismanaged. Since 1971, forecasters have been striving to develop rules of thumb relating to the interrelationships among exchange rates, interest rates, inflation, trade flows, and other economic variables affecting the international financial markets. But just when the forecasting community thinks a dependable rule has been found, it breaks down.

The challenge is clear: A consistent theory of economic behavior is needed to understand the workings of the foreign-exchange markets. As the great 19th century economist Alfred Marshall once put it, the facts are worthless without a theoretical framework. This is particularly true since the "facts," in terms of the observed statistical relationship between such variables as interest rates and foreign-exchange rates, keep changing.

The facts

For example, during the period 1976-1978, forecasters thought they had discovered two critical correlations: (1) When U.S. interest rates rise, the dollar falls, and (2) when the U.S. trade deficit increases, the dollar declines. For most of that period, interest rates, indeed, did rise, the trade balance did deteriorate, and the dollar did lose value on the foreign-exchange markets. The interest-rate effect was attributed to the idea that rising inflation means not only a weak currency but also higher interest rates in order to compensate for the declining purchasing power of the currency. The trade-balance effect was related to actual flows of money across national borders in payment for exports and imports.

In a subsequent period lasting from October 1979 through mid-1982, however, these rules of thumb proved useless: The interest-rate/exchange-rate relationship appeared to be reversed; whenever U.S. interest rates rose, the dollar strengthened. In addition, toward the end of the period, the link between interest rates and inflation was called into question. Inflation was falling and yet interest rates refused to follow.

Moreover, during this time the trade balance rule proved to be ineffective in projecting foreign-exchange movements. Flows of money between countries owing to imbalances in exports and imports were easily offset by capital flows, that is, by the international lending and borrowing of money. And whether the offset was overstated or understated depended on the interest-rate relationship and not the trade balance at all. Hence, having an accurate forecast of either the U.S. or foreign-trade balances meant nothing to the foreign-exchange forecast without a good projection for interest rates and international capital flows. Consequently, new rules were developed as some forecasters argued that the basic economic relationships had been permanently altered.

Starting in the summer of 1982, still a new relationship began to develop. U.S. interest rates have been declining, and yet the dollar has remained strong. The trade balance, as in the 1979-82 period, is still proving irrelevant to exchange-rate prediction. But in this "post-summer-1982" period, the interest-rate/inflation relationship that was observed over 1976-1978 seems to be returning. This time, inflation has slowed dramatically, setting the stage for declining interest rates within the context of a strong currency. And because of the improved U.S. inflation performance, among other things, capital flows have continued to be the critical variable for making accurate projections of the supply and demand for foreign currencies.

On the face of things, these historical data suggest some rather substantive changes over time in the interrelationships among interest rates, inflation, the trade balance, and foreign-exchange rates. However, those who can learn the lessons of these disparate periods and put them together into one consistent story are more likely to reap the rewards the next time things change. And things will undoubtedly change again.

A consistent approach

Actually, the problem is not nearly so difficult or confusing as it may seem. And in reality, the more things change, the more they remain the same—at least, for those who take the time to understand the underlying processes. The key is understanding a simple version of the long-run underlying relationships between variables—those that have withstood the test of time—and then modifying that simple approach during periods of transition from one government policy stance to another. In the short-run of course, say less than three years, the economy is often in a period of transition after either a major change in government policy or some unexpected external shock, such as the OPEC oil price hikes of 1974. During the adjustment period, some of the long-run relationships are temporarily altered as the economy moves from the "old long run" to a "new long run." And historically, adjustment periods have been anything but smooth.

Exchange Rates: Back to Long-Run Basics *(continued from page 7)*

Still, several fundamental long-run economic relationships must be kept in mind. The most basic of these for exchange-rate analysis is the link between the opportunity cost of holding money—the rate of interest—and inflation. Individuals and businesses simply do not hold on to cash if its value is being eaten away by inflation. Instead, the cash is invested to earn a return that is expected to cover the decline in purchasing power, at least. Borrowers in an inflationary environment, on the other hand, are willing to pay the extra interest because they expect to be repaying their debts in depreciated money.

Over the long run, the connection between exchange rates and inflation is built on exactly the same behavior. If inflationary policies cause the currency of one country to lose its domestic purchasing power relative to that of another country, the inflating country will find its exchange rate depreciating. If this did not happen, then someone would be able to buy goods cheaply in one country, sell them dear in another country, and—after converting the foreign exchange—make a tidy profit. Such arbitrage profits, however, simply do not exist for long—if at all.

Of course, relative inflation rates and exchange rates do not always move in lockstep. Many forces, including transportation costs, as well as tariffs and other trade barriers, cause the observed inflation/exchange-rate relationship to differ in the short run from its longer-term path. Conceptually, however, the long-run relationship is the one to depend on.

This means that, in general, over time, higher inflation portends both higher interest rates and a depreciating currency—as happened in 1976-1978. Furthermore, lower inflation usually foreshadows declining interest rates and an appreciating currency. The United States now seems to have moved into such a period, beginning in late summer.

As for what happened in-between, the 1979-1982 episode can be best explained as the transition period from high and rising inflation to lower and falling inflation. In such an adjustment period, many of the long-run economic relationships are temporarily suspended. Not because they have become any less valid, but because policy changes have real economic costs. In a perfect world, there would be no adjustment costs. The economy could move from one long-run environment to another without friction. In a less-than-perfect world, however, there are two principal reasons this does not happen: First, the future course of government policy—which is the dominant long-run determinant of inflation—is extremely uncertain. And second, people make long-term contracts that are not easily reversed or cancelled when policy changes course. The first reason leads to the payment of an "uncertainty" premium during any transition period. Since no one can be sure if the policy change is permanent or transitory, bets must be hedged. The second point suggests that mistakes will be made and that penalties for error will be extracted.

The past three years have witnessed a marked shift in U.S. monetary policy that has generated extreme uncertainty in the financial markets. Hence, the adjustment costs have been huge. The transition period, however, now appears to be over. And all of the markets—from bonds, to stocks, to foreign exchange—have begun to move in tandem, consistent with long-run, rather than short-run, market dynamics. It will be an unfortunate forecaster who fails to take note.

Long-run or transition period?

Knowing when the economy is entering an adjustment period is relatively easy. Since it takes a major economic shock, the evening news usually gives the first clue that a critical change has taken place. Such was the case when OPEC boosted oil prices in 1974 and when the Fed announced its major policy shift on October 6, 1979. What is much more difficult, however, is knowing when the adjustment period is coming to an end.

Generally, forecasters should be watchful for a return to long-run consistency in all related markets. The time-tested, long-run relationships suggest that when inflation is slowing, several other events should be occurring simultaneously, since they are all caused by the same underlying forces: (1) the currency should be strong, (2) short-term interest rates should be falling, (3) the bond market should rally, and (4) commodity prices should be depressed. When these variables start moving in tandem, then the adjustment period—the period of confusion—is ending.

Some of the key events, such as the decline in the price of gold and other commodities, began in 1980 and 1981. Some of them are just now being identified. The crucial point is that they all must be happening together. In late summer, when all signs pointed to a continued downtrend in inflation and interest rates started to fall, but the dollar remained strong and gold prices failed to climb toward the sky, it became clear that the long-run was returning.

Of course, this new long-run consistency among the financial, commodity, and foreign-exchange markets could disappear with the announcement of a major new event that would again alter the economic environment and necessitate large adjustments. But until then, it is time to enjoy lower inflation and interest rates and a strong dollar. *Bluford H. Putnam*